Client Alert

January 2021

Distressed Real Estate Loan Restructurings in the COVID (and Post-COVID) Environment

The COVID-19 pandemic has caused a "once in 100 years" crisis in many sectors of commercial real estate. Hotels, convention centers, restaurants, theaters, health clubs, and even office buildings around the nation were forced to close or severely limit capacity at times during the pandemic.

Many lenders and landlords have given extensions to debtors and tenants to make payments and offered forbearance agreements (if not formally, then informally). However, as weeks turned into months, often by necessity, enforcement actions were commenced. While some states instituted moratoriums on evictions, those moratoriums often do not apply to lawsuits to collect rent or even terminate a lease. In the lender/borrower context, moratoriums on foreclosures often do not preclude a mezzanine lender's UCC foreclosure sale, and foreclosures based on "pre-COVID" defaults were often not halted.

In this client alert, we address some key drivers in real estate restructuring negotiations that may impact leverage and negotiating dynamics. Both borrowers and lenders should be mindful of contractual dynamics at play when negotiating a real estate loan restructuring.

"Bad Boy" Guarantees

"Credit rated" securitized CMBS and similar loans are typically non-recourse, meaning the lender can only look to their collateral. However, non-recourse loans often require the sponsor to execute a "non-recourse carve out" or "bad boy" personal guaranty. These carve out guarantees are triggered upon delineated events, such as the filing of bankruptcy proceedings, fraud, waste, or other acts.

In any restructuring, borrowers, sponsors, and lenders alike should carefully review all triggering events. While it is sometimes clear whether a fact pattern will trigger "bad boy" liability, many are not, and some are prime for litigation. Over the years, the list of non-recourse carve outs has grown, including some that have not been tested in court. For example,

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some carve out events include even raising a defense to a foreclosure lawsuit. Could it be that raising a COVID-19 defense triggers the guaranty?

Guarantees and Deed-In-Lieu Exposure

Both completion and carry guarantees are common in many commercial real estate deals, especially construction loans. Carry guarantees require the payment of debt service, taxes, and related operational and maintenance costs but typically not the principal of the loan itself. In addition to sponsors providing them to lenders, mezzanine lenders are sometimes required to provide these guarantees to senior lenders, typically when the borrower tenders the pledged interests to the mezzanine lender.

Some lenders are unwilling to foreclose in the depths of the pandemic and borrowers are using lender unwillingness to "take the keys" as useful levers in restructuring discussions, particularly against "underwater" mezzanine lenders.

For borrowers, it is important to know if the mezzanine lender has carry guaranty exposure, as well as what rights exist (or don't) in the inter-creditor agreement ("ICA") among the lender groups.

Inter-Creditor Agreements: Inter-Lender Dynamics

ICAs define the relative rights between senior and junior lender. In any restructuring, it is vitally important to understand the rights and remedies of the respective lenders in the ICA. Below are some of the more important provisions in ICAs that often impact restructuring discussions.

Rights to Cure: As mentioned above, an ICA will typically grant the mezzanine or second lien lender rights to cure defaults to preserve the value of its position in the capital structure (typically when the junior lender still believes there is an equity cushion on its junior lien position). By curing and advancing to the senior lender, the mezzanine lender avoids default rate interest, penalties, and possible enforcement actions.

Parties should review the ICA to determine how long the cure right "window" is open. The mezzanine lender should fully understand not only the value of the underlying collateral prior to exercising the cure right, but also the full extent of borrower defaults and what the true cost of curing these defaults are prior to exercising the cure right.

Purchase Options: In addition to the cure right, ICAs typically grant the junior lender the right to purchase the senior mortgage upon a borrower default. Given the possible fast pace of enforcement actions, junior lenders

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should quickly assess the situation and begin discussions with the senior lender and, if needed, the borrower about a possible restructuring scenario.

Lenders facing this option will need to consider that it is not only agreeing to purchase the senior loan—but also possibly becoming obligated to fund ongoing taxes, maintenance, and other costs for struggling properties.

The borrower should also understand these rights, as well as the relative strength of the mezzanine lender (who may not have the financial ability or contractual right to acquire the senior loan) as these dynamics often become strategic levers in a post-default situation.

Sponsor/Related Party Loan Purchase: ICAs generally restrict a lender from selling its loan to the borrower or affiliates. These provisions often hamper many avenues to a sponsor-led workout and may, therefore, require amendment to allow for certain restructuring transactions, including possible sponsor-led discounted pay offs. As part of forbearance or loan modification negotiations, sponsors may wish to consider seeking amendment of these provisions to allow for the acquisition of the mortgage loan and a discounted pay off.

When we exit the pandemic, with the hope of vaccines and resumption of "life as normal," the need for commercial real estate loan restructurings and rescue financings will be essential for all parties.

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